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Economic Conditions
Governmental Finance
United States Securities

New York, September, 1945.

End of the War

THE end of the war has come suddenly, and in circumstances of unparalleled drama. It is now disclosed that by the middle of July the Japanese authorities had accepted the certainty of defeat and sought the services of Russia as mediator. The Allies' insistence on unconditional surrender, however, had been made plain long since. Mediation was properly refused, and while the Japanese were dallying the dropping of the two atomic bombs and Russia's declaration of war notified them that they faced not only early and utter defeat, but the most shattering destruction ever inflicted upon a modern industrial society. Within hours they gave up the struggle.

Thus comes to an end six years of the most widespread, stupendous and destructive warfare in all history. In this country, as among our Allies, the uppermost feelings are of joy and thanksgiving, that the bloodshed and waste are over and the long anxiety ended; of sorrow for the fallen; and of gratitude and admiration for the men who turned from peaceful occupations to outfight the best the Axis could offer, and won lasting credit for themselves and honor for the American name. With these emotions belongs a rightful pride in our country's part in the victory, in the mighty armies created and supplied, and in the staggering power of the navy and air forces. The production achievement exceeded anything previously believed possible, and the credit belongs alike to management and labor in the industries, to farmers and workers in transportation and other services. There is immense gratification in the showing of the power of a democratic people, devoted to peaceful ways, to meet and, with our gallant Allies, to overwhelm the challenge of totalitarianism and autocracy.

Looking Ahead

Mingled with these feelings are others of uncertainty and questioning as to the postwar situation. Throughout most of history wars were carried on chiefly by professional armies and battles were man to man. The demands on the civilian population were relatively small. The destruction of life and accumulated wealth and the interference with normal and orderly existence were for the most part limited. But the history of the past six years has shown, in vastly greater degree than even the war of 1914-18, that wars now are total wars, in which the lives and property of all people are exposed, and in which all effort must be mobilized for the common purpose.

In the modern world the industrial and financial organization is almost incomprehensibly complex. The division of labor and the variety of production and exchange of goods and services have become constantly greater, and all the parts of this vast system are mutually dependent to an extent unknown in earlier days. The system has yielded immeasurable benefits to all the people engaged, by raising standards of living. It depends for its functioning, however, upon peace, order and balanced trade, and the effect of total war upon it is one of violent disruption.

This system was disrupted in 1914-18, and now again. The problem is to avoid a repetition of the chain of effects — the inflation and deflation, boom and depression, monetary, fiscal and social disturbances — which followed after 1918 and led in unbroken sequence to the new war. If the lesson of 1914-18 means anything, it will be seen as time goes on that the gravest effect of the war is not the physical destruction, appalling as that has been, but the disorganization of economic and social relations. Destruction can be made good by new production, but production does not go ahead efficiently without order and cooperation. After the first World War the world suffered from the destruction of industrial plants, homes and transportation for only a short time, but it suffered from distortion of price relationships, barriers to trade and fiscal and monetary disorders for twenty-five years, at the cost of a great depression, vast unemployment and ruin for farmers and business men in untold numbers.

To talk of a restoration of some past condition in world production and trade is idle, for

there can be no such return. New boundaries, population shifts, new national policies, new inventions and technological changes, the necessary measures to make it impossible for Germany and Japan to make war again, — all forbid a return. Rather it is necessary painstakingly to work out many new patterns of economic and social relations, through the effort of all the people concerned. The qualities required are the old-fashioned virtues of patience, industry, forbearance and cooperation. The problems of the war-ravaged countries are immensely more acute and complex than elsewhere, but in all countries there is a common problem, namely, to get the economic organization working, to increase its output, to make good the war's destruction, relieve distress and suffering, and resume historical progress in raising living standards.

In all countries the test of ability to recover from the war and regain a state of prosperity is in the capacity to produce a flow of goods and supply the wants of the population. There is no other measure of the general welfare than the production, distribution and consumption of goods and services. If production is insufficient, distributions of money, whether in the form of international loans or internal "relief," will be unavailing in recovering the standard of living. The problem is obscured by thinking of it in terms of money.

Reconversion in the U. S.

In the United States it cannot be doubted that the material elements necessary for a state of prosperity, including natural resources, labor and industrial capacity, are present in abundance. The country has suffered no destruction or loss of its means of production during the war, but on the contrary probably has had an increase, assuming that the addition of war plants and machinery which can be adapted for peacetime use has more than offset depreciation of old plants and machinery. In shipping, the net gain is enormous. Immense technological progress has added to our productive power.

Nor is there much doubt that a period of great activity awaits the country as soon as readjustments to a peacetime basis are made. Inherently the business outlook is strong. Stocks of many kinds of goods are low, much household, transportation and industrial equipment is worn out or obsolete, and needs are pressing. Construction and repair work are behind. The country could have done a huge cash export trade in the past year if goods and shipping had been available, and buyers abroad want to make up their arrearages as well as buyers at home. Unquestionably heavy demands are waiting, ready to come forward when the country is able to supply them at a price level satisfactory to buyers.

Doubts therefore relate to the transition or reconversion period. Materials, plants and workers have been mobilized to give war production priority, and now a reorganization is required. Some industries and communities must shrink, others expand. Men and women from the armed forces and the war factories must come back into occupations where everything they produce must be taken off the market by public demand. The productive organization must be reshaped, from a situation where many plants have worked largely for one customer, back to filling the wants of a multitude of customers. The process must work itself out, and there are inevitable difficulties.

The Physical Problems

General opinion probably attaches most importance to the physical problems of reconversion, such as the clearing of plants of war inventories and their re-equipment, re-direction of the flow of materials and parts, and shifting and retraining of workers; and contentions that the country faces a "great emergency" are based largely on these difficulties. Without belittling them, it is likely to be seen in due course that these are the minor and temporary problems. Many industries do not have to reconvert at all, and in those that do preparations are well advanced. It has become plain that industrial leaders generally know what they are going to do and how to go about it, and that they are moving energetically both out of a sense of public responsibility and because they see vast markets waiting for their products. The competitive influence is working along with all the others.

Contract termination procedures are excellent and settlement or part payments are as prompt as could be expected, considering the magnitude of the task. The strength of the financial resources available to the industries for reconversion is one of the elements fortifying confidence.

The sudden ending of the war and the abrupt termination of war work will facilitate the reorganization of production. It will make ample supplies of materials, machines and labor speedily available, and thus will relieve "bottleneck" difficulties. In this Letter last month we expressed the opinion — without anticipating that the event would come so soon — that an early end of the war would facilitate reconversion by clearing the industries of war requirements; and that, while the drop in employment temporarily would be greater, volume production of peacetime goods would be reached more quickly, and recovery within a few months would be farther along, than if war work were ended more gradually. This optimistic view has been strengthened since the Japanese surrender.

From all sides, with the giant automobile and electrical equipment industries in the lead, have come reports of reconversion progress and increases in production schedules to take effect as soon as production can be resumed.

Removal of Government Controls

Finally, and perhaps most important of all, the policies of the Federal Government and the measures taken by the federal agencies imply in general that reliance for rapid reconversion is being placed upon the ingenuity and resourcefulness of business men themselves, and not upon schemes for government direction and control. Nothing was more to be feared, either for the transition period or the longer future, than regulations subjecting every major decision of business to the approval of Washington, with the certain result of confusion, delay, mistakes and injustices. But the moves since the surrender have shown that the policy is to free business of interferences with production — in some respects at once and in others gradually — and put it on its own.

The first step was to cancel war contracts promptly, in order to cut the cost and stop the waste of war, reduce the inflation danger, free materials, machines and labor for peacetime goods, and clear the decks for a fresh start. Any other course would have hampered reconversion. The policy was laid down by Mr. Snyder, Director of the Office of War Mobilization and Reconversion, in his report to the President August 15, as follows:

> Nor will we continue the manufacture of useless armaments for as much as one day to cushion the shock. We will not manufacture a single shell, nor a single piece of equipment above absolute minimum military needs, for the purpose of reducing the shock of terminating war work. We will not keep a single soldier or sailor in uniform longer than he is needed by the Army or Navy, in order to hold down the totals of temporary unemployment. This is the policy laid down by the Congress, wholeheartedly carried out by this Administration, and backed by the American people.
>
> This policy may increase somewhat the immediate dimensions of the task. But it is the shortest and most efficient road back.

The second step was to remove most of the wartime limitations on production and on the use of materials. Mr. Krug, chairman of the War Production Board, has moved rapidly, rescinding limitation orders except in the case of certain critically short items, and in general freeing the industries to go ahead without having, as the Truman Committee report in 1944 said, "to go to Washington with hat in hand." The W.P.B. moves have been in accord with the promise of Mr. Krug in his policy statement of May 28, when he said:

> It is necessary to get rid of regulations and production limitations as quickly as possible. They automatically put ceilings on initiative, imagination and resourcefulness, the very qualities the country will need most if we are to have a resilient and rapidly expanding economy after the defeat of Japan . . .
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> The danger confronting us, as I see it, is that we will overlook the natural resilience of the economy — the capacity of manufacturers, wholesalers and retailers to readapt themselves to changed conditions and hence quickly to utilize the resources released from munitions production. If we were to attempt in Washington to see that every manufacturer, wholesaler or retailer got his exact share of released manpower or materials, we should be lost in a myriad of rules and regulations. We should get in the way of reconversion rather than speed it.

As long as the policies of government are in harmony with these principles, the energies, abilities and experience of millions of business men will be at work, each on his own problems, to get factories retooled and speed production of civilian goods. No other forces that could be exerted in the situation could possibly be as effective.

To be sure, a minority of commentators deplore the absence of an overhead "plan". What they overlook or ignore is that the kind of plans which will do most to shorten the period and get people back to useful and self-supporting work are the plans of business men themselves. The allegation that there has been a "lack of planning" does not stand analysis. Probably there has never been a time when planning, at the level where it counts most, has been as widespread and as ably done.

It is in order also to repeat what has been said in previous issues of this Letter, that the decisions being taken now will exert a lasting and profound influence upon the nature of our economic system in years to come. The wartime controls have a natural tendency to perpetuate themselves, through inertia, through fear of the transition, through lack of understanding, and because some of those exercising power desire to retain it. The overwhelming majority of the American people, however, believe that detailed regulation of business in peacetime would be wholly impracticable and disastrous in its consequences upon production and employment. Mr. Krug and Mr. Snyder, out of their wartime experiences, take that view. The country will have many occasions to be grateful that in this decisive period the turn has been made in the direction of freedom for enterprise. Other steps along the road should follow in natural order, and in due course. New attitudes will be required in some quarters, both in Washington and in business. Business men who have learned to lean on governmental decisions, priorities or subsidies may dread to lose them, but they cannot expect to get rid of government controls if they continuously ask for government help.

Forecasts of Unemployment

In general, business men share an optimistic view of the readjustment period and con-

fidence is reflected in well-maintained trade and rising stock markets. But there is a dissenting view, expressed by labor leaders more than others, which foresees a "great emergency," and this opinion contributes to confusion and uncertainty. It holds that even though the energies of private enterprise are enlisted and given scope, private enterprise alone will not be enough, and that positive government action to provide or stimulate employment is called for. Sidney Hillman, national chairman of the C.I.O. Political Action Committee, was quoted in the press August 14 as estimating that "ten million workers will be out of work within the next six to eight weeks," and as demanding more government relief and support.

This view evokes memories of 1918 and early 1919, when there was also anxiety in labor circles as to the possibility of a "dangerous situation" resulting from unemployment. Mr. Hillman's prediction may be the up-to-date counterpart of the statement made by Frank Morrison, Secretary of the American Federation of Labor, before the House Immigration Committee January 16, 1919, that "we are going to have bread lines in every industrial center by May 1."

Mr. Morrison's fears, however, were not substantiated. The Federal Reserve Bulletin of March 1, 1919, stated that "reports as to labor unemployment have been numerous in the press, but the reports of Federal Reserve Agents show that there has probably been overanxiety and exaggeration with respect to this matter." The Bulletin dated May 1, 1919, referred to business improvement and said, "The floating supply of labor which had threatened a considerable amount of unemployment during the months of February and March has been partially absorbed."

By August 1 the Bulletin was referring to "fear of an impending shortage of labor." According to the statistics of the National Industrial Conference Board, the average volume of employment in 1919 exceeded the normal labor force, due to the continued employment, as during the war, of people not ordinarily counted in the labor force.

A more recent experience was the fear of "priorities unemployment" in 1941, accompanying the conversion of peacetime industry to war work. Estimates of the extent of this unemployment, ranging as high as 3,000,000 workers, proved to be absurdly exaggerated, and proposals for a federal relief program, though pressed as a matter of great urgency, died a natural death as the facts developed.

Mr. Hillman's figure of ten million far exceeds other estimates of probable unemployment in the present reconversion period, and in our judgment statistical support for it, and for other high estimates, is lacking. Of course the unemployment actually is unpredictable, because it is not foreordained. It depends upon many circumstances, among others the willingness of labor to work for wages which employers, who must sell their goods and services to the public, can pay. There is evidence from all centers of shortages of workers in the trades and services, but thus far many of the released war workers refuse such work, clinging to the hope that they can find jobs at wages closer to what they made in the war plants. The economic organization can give them no guarantee of such jobs.

Danger of Exaggerated Estimates

The danger in forming an exaggerated view of the probable unemployment is that people may be driven through fear to endorse programs for making work, or for greatly extending unemployment compensation and easing the qualifications for it, which if adopted would interfere with reconversion and readjustment. Of course worthy public works projects such as road improvement, long needed and deferred during the war, and for which funds have been set aside and plans prepared, should now stand on an equal footing with private work, and if they can be carried out during the transition period it is particularly desirable to do so. Projects designed primarily to give employment under the plea of emergency, however, fall in a different category. They are wasteful, costly, and inflationary. The indications are that before most such projects could be started the "depression" will be curing itself, and "made work" then would compete with the industries for men and materials and add to the inflationary forces.

The unemployment compensation funds of the states have reserves amounting to over $7 billion, created to help workers through temporary unemployment. These are the funds which should bear the impact of reconversion upon displaced workers. Also, it is a sound rule that unemployment compensation rates should be less than the wages obtainable in self-supporting work, and the regulations requiring those on the rolls to accept available jobs should be strict. Otherwise, how can employment be restored in the trades and services, the laundries and cleaning establishments, and all the other essential businesses which have been and are still short-handed?

Costs and the Inflation Danger

Fundamental questions of adjustment to peacetime conditions are involved in the proposals for making work, for increasing unemployment compensation through federal appropriations, for 20 to 30 per cent advances in wage rates, higher statutory minimum wages

and similar measures. We said earlier in the discussion that the physical problems of reconversion in time would be seen to be the minor and temporary ones. The major and longer-range problem is to work out the necessary adjustments in trading relations, or in other words in wages, costs and prices, so that trade can go forward, production can be carried on, and the product distributed and the markets cleared.

Some may think there is little cause for concern over cost and price relations, in view of the strength of the waiting demand and the unprecedented amounts of money which people are holding. They will argue that business can pay increased wages, and that sustained take-home pay is necessary to absorb production. But such comments overlook the main point, which is the inflation danger, and the influence of wage rates on costs. It is perfectly possible to have for a time a large volume of trade at inflated costs and prices, supported by the huge money supply and exaggerated, if experience is a guide, by speculation, inventory accumulation and extravagance of many kinds. This, however, is precisely what all sensible persons fear. It is an inflationary boom. Our greatest anxiety is to avoid it and escape a repetition of what happened after World War I. What is needed is stability and order, efficiency in production, and practicable cost and price relationships, so that trade can go forward continuously, not on boom terms but on a sound and lasting basis.

The rise in unit costs of civilian products during the war has been general and substantial, due primarily to wage increases but in many cases also to lower output per worker. Doubtless man-hour output will be increased as the situation changes and inefficient workers are weeded out. Greater efficiency and elimination of overtime and upgrading will tend to reduce unit costs. On the other hand, the industries must figure in sales and distribution costs again; in most cases they will have lower volume; and they are deeply concerned with the danger of labor disturbances, restrictive union practices and similar cost-increasing factors. It is generally agreed that the present cost of living and the inevitable decline in take-home pay forbid general cuts in wage rates, but costs of industrial production should come down nevertheless, for many people are due to suffer a loss of money income and the situation will be out of balance unless the goods they want are priced at what they can pay. Construction costs are of vital importance, for much construction can be postponed and will be if costs are excessive.

The way to reduce costs without reducing wage rates is to improve productivity. Every obstacle to an increase in productivity is a menace to prosperity.

Inflation or Deflation?

Confusion as to whether the country should fear inflation or deflation most is evident in many quarters. In our opinion the evidence is convincing that the reconversion depression will be relatively short, and that accumulated resources and arrangements for relief and support already made can carry the country through it without widespread distress or crisis. If this is correct, then the sound public policy is to avoid more intervention than is already planned, to trust in the recuperative power of the industrial organization, and give it time to turn around and get on its feet. Moves in the contrary direction, involving either large government expenditures or measures that would increase industrial costs, would add to the inflation danger. They would be self-defeating, so far as encouraging a sound recovery is concerned, by reason of the interference with normal adjustments.

The responsibility for working out sound trading relations and a sound price structure belongs to everyone. It cannot be done successfully by arbitrary authority. The Government has the greatest responsibility, since it is maintaining controls over prices and over wages wherever prices would be affected by increases. It must strike a proper balance between the twin objectives of holding a stable price level and facilitating and encouraging production. Business has the responsibility of setting prices at levels which will achieve maximum output and distribution of goods, and seeking profits in volume rather than in exorbitant margins. Workers for their part have to realize that they face new conditions. There was never any danger that the cost of war products would price them out of the market, for the armed forces had to pay what was required. But civilian buyers are not usually in that position. The wages that industries can pay for peacetime work are limited by what consumers can pay for the product, and in the long run this will be the governing factor.

Everyone can contribute to stability by exercising restraint. The practical sense of the American people should tell them to refrain from buying what they do not urgently require, until supplies become more abundant; and the whole position will be benefitted if ordinary buyers give way to returning veterans and others whose needs are pressing, and reserve their own buying power until the markets are again well-filled.

The economic organization is a team, and it must work together, — first to produce, to supply the markets, absorb the inflationary pressure, keep down the cost of living and so promote order and stability; and second, to produce at low costs, through hard and ef-

ficient work, in order to broaden markets and resume the historical upward trend of living standards. All elements in the organization stand to gain by placing emphasis upon hard work and productivity, and upon the functioning of the team, rather than upon makeshift government expenditures. We repeat that for the long run the major problem left by the war is the establishment of equitable and practicable cost and price relationships, on which production can go continuously forward in stable and orderly fashion. The gravest danger, creating instability and disorder, would be a rise in industrial costs.

Budget Outlook and Fiscal Policy

With the ending of the war, Treasury finance faces "reconversion" problems comparable in magnitude and urgency with those of the industrial organization. Just as fiscal policy has been a powerful instrument for mobilizing the economy for war, so it may now be of inestimable importance in adjusting the economy to peace. Involving as it does problems of taxation and borrowing, it will determine very largely not only our ability to steer a safe course between the twin evils of inflation and deflation, but also — and far more fundamental — our success in getting a resurgence of free enterprise. The way we handle these problems will play a big part, perhaps a deciding part, in shaping the kind of economy we are going to have.

The problems of postwar fiscal policy fall into two broad classes: first, the immediately pressing problems of adjusting the budget and borrowing program to the rapidly shrinking requirements of a country passing from total war to peace; and, second, the more distant problems of determining fiscal policy after peace-time equilibrium has been restored and of managing a national debt of close to $275 billion, some six times greater than before the war. Granting that this distinction is to a certain extent arbitrary (since much that we do now is bound to influence the long-range pattern), both classes of problems are of major concern to the American people.

The Revised Budget Estimates

Of the various questions revolving around Treasury finance, a key question relates to the budget outlook over the next couple of years.

Total government expenditures in the fiscal year ended June 30, 1945 were at a peak of approximately $100 billion, of which $90 billion was for war. For the fiscal year 1946, they were estimated in President Roosevelt's budget message submitted to Congress last January at $83 billion, with war expenditures lowered to $70 billion.

On August 1, Budget Director Smith issued a revised estimate of $85 billion, which gave effect to the cost of the new international postwar obligations assumed by the United States in connection with our subscription to the two Bretton Woods institutions—the International Monetary Fund and the International Bank for Reconstruction and Development — and with our subscription to the enlarged capital of the Export-Import Bank, both authorized by the Congress in July, but continued the $70 billion estimate for war expenditures, despite the conclusion of the German war.

Following the surrender of Japan, Mr. Smith issued on August 30 a second revised estimate in which war expenditures were dropped to $51 billion, and total expenditures to $67 billion.

On the side of revenue receipts, the revised estimates for this fiscal year were marked down twice from the January forecast, reflecting the new business-aid tax law permitting corporations to take certain refunds currently instead of waiting until the end of the war, and also the expected effect of the cut in expenditures on national income and tax payments. Compared with the $46 billion record collection for the fiscal year just closed, the latest revised estimates for this year showed a reduction of $10 billion.

On the basis of the foregoing revised estimates for expenditures and receipts, the federal deficit this year would total $31 billion, against $41 billion estimated last January, and an actual deficit of $54 billion in fiscal 1945. The federal debt as of June 30 next is expected to reach $273 billion. The following table shows the original and revised official estimates of federal receipts, expenditures, and debt for the current fiscal year compared with final figures for 1945 and previous years since 1939:

United States Government Receipts, Expenditures and Debt
(In Billions of Dollars)

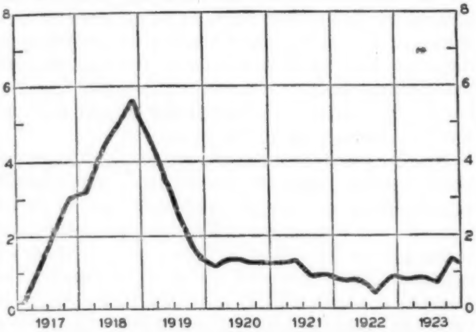
Year Ended June 30	Total Expenditures	Total Net Receipts	Net Deficit	Debt at End of Period
1939	$ 8.7	$ 5.2	$ 3.5	$40.4
1940	9.0	5.4	3.6	43.0
1941	12.7	7.6	5.1	49.0
1942	32.4	12.8	19.6	72.4
1943	78.2	22.3	55.9	136.7
1944	93.7	44.1	49.6	201.0
1945	100.4	46.5	53.9	258.7
1946 Estimate				
Orig. (Jan. 9)	82.5	41.3	41.3	292.3
1st Rev. (Aug. 1)	85.3	39.0	46.3	295.2
2nd Rev. (Aug. 30)	67.3	36.0	31.3	272.9

Receipts exclude old-age insurance tax receipts; and expenditures exclude appropriations to old-age insurance trust funds, net outlays of government agencies, and sinking fund for debt retirement.

The Prospect Since V-J Day

The latest budget revision indicated that total expenditures are expected to decline in

a pattern similar to that of the period after the armistice in 1918. At that time the peak of quarterly expenditures was reached in the quarter ended December 1918, with a total of $5.7 billion. From there on, expenditures fell precipitously, as shown by the accompanying diagram, and within one year, or by the December quarter of 1919, were down to $1.4 billion, or 25 per cent of the peak, at which the rate levelled off. With improved tax collections resulting from increased taxes enacted shortly before the end of the war, the budget was actually showing a surplus in the December quarter of 1919.



Total Government Expenditures During and After World War I. Figures (In Billions of Dollars) by Quarters and by Calendar Years

Turning to the present situation and applying the above pattern of decline to the current expenditures, now running at a rate of approximately $24 billion per quarter, would bring the rate down to around $6 billion for the September 1946 and subsequent quarters, and mean total expenditures for the fiscal year 1947 of but $24 billion. No official budget estimates have yet been issued for 1947, but if expenditures were held to that level, and if total receipts — placed at $36 billion for this year — should decline by, say, one-third, to $24 billion next year, there would be practically a balanced budget.

Much of course will depend upon government policies with respect to liquidation of of war agencies, unemployment relief programs, advances for foreign reconstruction, etc., as well as the policy with respect to downward readjustment of tax rates.

The Policy on Taxes

Now that the war is over and government expenditures are due to decline, business and the public generally are looking forward to an early reduction of tax rates. Administration and Congressional leaders have both recognized the importance of some relief from the extremely high wartime levels in encouraging incentive during the transition period, and have indicated support for a program of adjustment to take effect January 1 next. The only real question has been, how much and in what manner taxes should be cut.

There is a natural eagerness on the part of all taxpayers to be relieved as rapidly as possible of their wartime burden. At the same time, it must be recognized that — as the above figures show — war spending cannot be chopped off abruptly with the declaration of peace, nor will the deficit disappear overnight. Even under the most favorable conditions the deficit this year is bound to be stupendous, measured by any standard other than the fantastic sums of the war period, and every dollar of deficit means so much more debt piled up and so much more danger of inflation. If we want to preserve the stability of the dollar and protect the millions of investors in savings bonds we must collect enough taxes to close progressively the deficit gap as expenditures decline.

Among the proposals under discussion has been the elimination of the corporate excess profits tax. Opinion generally has been favorable right along to the repeal of this tax as soon as possible after the war. It is widely recognized that this type of tax — however justifiable in time of war when the Treasury needs all the money it can get from all kinds of taxpayers, when the earnings of business are largely the product of the Government's own enormous spending, and when the whole economy is under controls — is utterly unsuited to peacetime conditions with free competitive markets and reliance upon profit incentives. The only argument about repeal has been as to timing, and whether by one move or by stages. Since this tax bears heaviest upon the more efficient and rapidly growing enterprises, it would seem that the sooner it is done away with entirely the better. In event of repeal, retention of the carry-back of unused excess profits tax credits would be necessary as an equitable measure in view of the disallowance during the war of tax deductions for the purpose of establishing postwar reconversion reserves. The effect of repeal upon federal revenues would be far less than the amount of the tax, inasmuch as the corporation income thereby released would become fully subject to the 40 per cent corporate normal and surtax.

Also under discussion is the possibility of affording some relief to individual taxpayers either through repeal of the present 3 per cent normal tax or by allowance of a flat percentage credit against the overall tax, combined possibly with some increase in the present $500 per capita individual exemption. This is just as much a necessary part of a postwar tax pro-

gram as giving relief to business. If people have the spending of their own money, they will do it in ways that create more useful employment and production than if the Government takes the money and controls the direction of spending. Individual as well as corporate incentives need to be preserved, and the fact is that under the present tax structure there is precious little inducement for anyone to exert the extra effort, or step out and take the additional risks, needed to keep the economy moving ahead.

This is true all up and down the income scale but especially true in the high surtax brackets where two-thirds and more of every additional dollar earned goes to the Government. While it may not be possible to reduce individual taxes very much at the start and still maintain the flow of revenues needed to hold down the deficit, even a little reduction would afford some relief and have a vastly encouraging effect psychologically; and it would always be possible, under the pay-as-you-go system, to put into effect further reductions later in the year should budget developments warrant.

Reductions after January 1 in individual taxes, which are on a pay-as-you-go basis, would affect federal revenues only in the second half of the 1946 fiscal year; and reductions in corporate taxes, which are payable the following year, would not affect revenues until the second half of the 1947 fiscal year. Under the present revenue law, many of the most recent wartime increases in excise and miscellaneous taxes will automatically expire six months after the official ending of the war.

Some Permanent Gains in the Tax System

In the process of financing the war, certain gains may be noted in the tax system that we shall not want to relinquish. One of these is spreading the personal income tax so that a much larger number of people are paying something, even though in many cases only a little. This broadening of the tax base has the advantage both of making many more people conscious of contributing toward the costs of government, and of adding greatly to the stability of federal revenues.

It is indeed inescapable, in view of the huge volume of debt created and of conservative estimates of government expenditures after the war, that many more people will have to share directly the tax burden than ever before in time of peace. While the principle of graduated taxation in accordance with "ability to pay" is well established in our tax system, nevertheless there is no longer enough income in the upper brackets alone to carry the load that will have to be carried after the war. As was aptly stated in a quotation in our February 1944 Bank Letter from a report of the Joint Congressional Committee on Reduction of Non-essential Federal Expenditures, headed by Senator Byrd, —

> There was a time when the federal income tax was called a rich-man's tax; the masses believed that they would benefit and that the wealthy would pay the bill. Today all that has changed. From now on our federal expenditures will be traced directly to tax burdens in the lower-income brackets, it being estimated that 50,000,000 people will now file income-tax returns.
>
> The Secretary of the Treasury must have had a similar idea in mind when he stated: "For the first time in our history the income tax is becoming a people's tax."

While tax revision will reduce the number of taxpayers from the wartime peak, it will nevertheless be true that, to a far larger extent than in the past, beneficiaries of government largesse will find themselves footing the bill. Politicians, pressure groups, "wealth distributors", and the public generally might find this worth keeping in mind.

Another wartime improvement in the tax system that has proved its worth is the plan of withholding on wages and salaries, which is almost indispensable when large amounts of taxes are to be collected from vast numbers of people. The same can be said of the pay-as-you-go system which couples taxes with income as earned, instead of falling due a year later when the money may have been spent.

The tax system admittedly has many weaknesses in it, and needs a careful review as to the effect on enterprise and as to technical and administrative provisions. But the wartime experience has at least shed a good deal of light on these problems.

Treasury Borrowing Requirements

Meantime, while looking forward to some tax reductions, the country faces continuing large scale public debt operations. As figures above have shown, the war is by no means over so far as the federal deficit is concerned. We must still plan to finish the job of financing that has to be done until income and outgo are once more in balance.

For that purpose the Treasury has announced a Victory Loan — probably the last of the war loan series — to start October 29, with a goal of $11 billion. In announcing the drive, Secretary Vinson stressed that while the present Treasury general fund balance is "large," there have been "enormous obligations incurred in the achievement of victory, including those for materials and ammunition already delivered and used." Against a possible deficit this fiscal year of $31 billion, the Treasury had a cash balance July 1 last, after the 7th War Loan, of $25 billion. This is expected to be drawn down to $8 billion by June 30 next, leaving $14 billion of the deficit to be financed by borrowing.

Already, however, $4 billion of debt increase had been financed up to August 28 — $1 billion

in special issues to the social security fund and $3 billion in net sales of Treasury bonds and savings bonds — reducing the deficit to be financed during the remainder of this fiscal year to $10 billion. Assuming that social security and other government trust funds take $3 billion of this, the amount left for open market financing, including regular sales of savings bonds and tax notes, would be only $7 billion.

On this basis, the projected total of $11 billion for the Victory Loan appears to allow ample margin, especially in view of the likelihood of its being considerably oversubscribed. The Treasury, however, will want all the money it can get from genuine savings, for it can always use such money to take up securities held by the banks. Moreover, it will need to be well on the safe side by reason of many uncertainties, including both the possibility of underestimating the deficit and uncertainty as to the course of sales and redemptions of savings bonds and the extent to which corporate owners of tax notes and other short-term government securities may cash in their holdings during the reconversion period.

Savings Bond Redemptions and Corporate Liquidation of Governments

The latter question is of interest because of its bearing not only upon Treasury borrowing requirements but also upon the trend of bank credit and bank deposits. If savings bonds and business holdings of governments are redeemed or allowed to mature in substantial quantity in excess of new purchases, the Treasury will have to borrow from other sources, principally the commercial banks. Also, any important selling of governments in the market by corporations or other holders presumably would be absorbed mainly by the banking system. In either case the effect would be to expand bank credit and deposits, which is inflationary.

The question as to how heavy savings bond redemptions and corporate liquidation of governments may actually prove to be cannot, of course, be answered in advance. Undoubtedly, a great many individual holders will want to cash their savings bonds and have money to spend for new civilian goods coming on the market. At the same time it is to be noted that of the $46 billion of savings bonds now outstanding, $13 billion, or 28 per cent, is represented by F and G bonds sold largely to trust funds and institutional buyers, not likely to be ready redeemers.

Moreover, large amounts of E bonds have been sold to medium-income investors, many of whom will hold them, especially in view of the rapid step-up in the rate of return as the bonds approach maturity. One-third of the total dollar sales of E bonds have been in denominations of $500 and $1,000, the redemption rates of which have been considerably lower than those of the $25 to $100 denominations. In the wage-earning group the influence of the habit of systematic saving, induced by the payroll savings plan, should not be overlooked. This method of financing is one of the fiscal "discoveries" of the war. Its continuance after the war, as announced by the Treasury, together with regular sales of savings bonds to the public generally, should be an important offset to any temporarily heavy run of redemptions resulting either from an initial spending spree or spell of unemployment, and over the long run serve as a steady source of funds for the Government.

As to possible shifts in business holdings of governments, we give figures below from the June 1945 Federal Reserve Bulletin showing the estimated ownership of such securities by business organizations other than banks and insurance companies as of the end of last year, with comparative figures for December 31, 1939.

Ownership (Partly Estimated) of Government Securities by Business Organizations
(In Billions of Dollars)

	Dec. 31, 1939	Dec. 31, 1944
Business corporations	$2.1	$23.1
Unincorporated business	1.1	9.0
Total	$3.2	$32.1

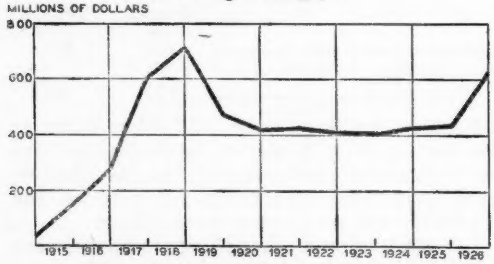
Business holdings were not broken down in this survey as to types of securities, but are believed to be predominantly in the shorter-term issues and to account for most of the $10 billion tax notes now outstanding.

The tax note and other short-term issues are held largely against federal income and excess profit tax liabilities, the amount of which was not reported. A broad study by the S.E.C., however, of the working capital of all American corporations except banks and insurance companies, based upon the balance sheets of listed corporations and other sources, estimated that total government security holdings at the end of 1944 were $20.8 billion, against a federal tax liability of $16.0 billion, indicating some $5 billion to spare after payment of taxes, without allowance for use of cash balances or liquidation of inventories and receivables against payment of other current liabilities. The estimated "working capital" or net current assets of these corporations rose from $24.6 billion in 1939 to $45.5 billion in 1944 so that, assuming that the wartime expansion in current assets and current liabilities could be liquidated at the values stated, there was a gain of $21 billion in working capital that might remain invested in government securities for an indefinite period.

This excess of working capital takes no account of the cash that will be put into fixed assets by expenditures for deferred maintenance, installation of new equipment, purchase of war plants, operating losses during recon-

version, etc.; or of the additional cash that will shortly become available for working capital through the revenue law changes permitting prompt tax credits and refunds and making the postwar excess profit tax refund bonds redeemable on January 1, 1946. Working capital of course is not evenly divided; many companies will end the war with an excess, while others have already indicated their need for substantial borrowing from banks or other sources to finance postwar business. The figures taken as a whole, however, suggest that a large portion of the $32 billion of government securities is likely to be retained by business as a secondary cash and investment reserve.

Statistics for all corporations are not available as to changes after the last war in ownership of government securities, but a tabulation of holdings of "marketable securities" by 81 large manufacturing corporations, given in a study entitled "Corporate Cash Balances, 1914-43" by Dr. Frederich A. Lutz published by the National Bureau of Economic Research, showed the following changes:



Year-End Holdings of Marketable Securities by 81 Large Manufacturing Corporations

The holdings, which amounted to only $34 million at the end of 1914, rose to over $700 million in 1918 just after the armistice, from which there was a decline of 34 per cent in the next year, or 42 per cent in the next two years, leveling off at somewhat above $400 million.

Policy as to Interest Rates

During the war it has been the policy to finance at low rates on a scale ranging from ⅜ of 1 per cent for 90-day Treasury bills to 2½ per cent for long-term bonds. This policy has been made effective mainly by the discount and open market operations of the Federal Reserve Banks. The latter have stood ready to make loans to member banks at ½ of 1 per cent against short-term governments, and to purchase all Treasury bills offered by the market at the pegged rate of ⅜ of 1 per cent. Rates on Treasury certificates, notes, and longer-term securities, while not rigidly frozen in the manner of bills, have been closely controlled by the buying and selling operations of the Reserve Banks.

That money and credit policy after the war will continue to be directed towards maintaining low interest rates has been made abundantly clear by official pronouncements both here and abroad. Everywhere governments are interested in keeping down the interest cost of their heavy debts accumulated during the war, and in maintaining the market prices of their securities now outstanding with the general public, banks, and other institutional investors.

In estimating the ability of governments to achieve these objectives, the effectiveness of "money market management", exercised through the central banks, must not be underrated. There is no doubt that the monetary authorities can maintain a high degree of control over interest rates, even in the face of strong opposing forces, if they are willing to pay the price. That price is an inflation of bank credit, brought about by use of the banking system (including the central bank) as the instrumentality for supporting the bond market and keeping up the supply of loanable funds.

To pay this price in war, when large scale expansion of bank credit is unavoidable and when prices, wages, and other economic conditions are under close controls, is one thing. To pay it in ordinary times of peace is quite another matter. There will be periods of expanding credit and activity when interest rates are prone to rise which will put these policies to the test. The question will be whether it is in the national interest to hold rates by an expansion of credit or whether it is better to let rates rise instead.

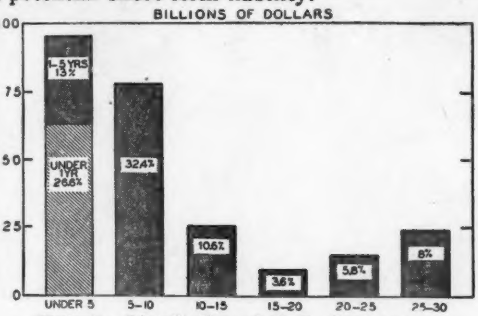
Indications that money market management will be further complicated by attempts to control the "structure," or pattern of rates in different maturities, as well as the general level of rates, have become apparent in recent months in the growing tendency for investors to reach out for the longer-term, higher-yielding issues now coming to be regarded as practically as "safe" as the short.

With interest rates at the short end of the scale pegged down by the Reserve Banks, the commercial banks are encouraged to sell, or discount against, their low-yielding, short-term governments at the Reserve Banks, and utilize the proceeds to bid in the market for the medium- and longer-term issues bringing better returns. This has the double effect of bringing about an undue absorption of government securities by the banks, and of pushing up prices and depressing yields of the medium- and longer-term issues.

How far these tendencies will operate is impossible to say; but the question may be raised whether attempts to maintain the present rate structure will not mean continuing credit expansion and pressure upon the longer-term interest rates, to the detriment of savings banks, insurance companies, charitable and educational institutions and other investors.

Short-Term Debt — To Fund or Not to Fund

The problem of handling the "floating" debt falls within this same area of money market management. Its magnitude is suggested by the following diagram showing that of the $240 billion publicly-held debt on July 31 (exclusive of $22 billion of special issues and noninterest-bearing debt), the amount maturing within one year totalled $64 billion or 27 per cent, and that maturing within approximately five years totalled $95 billion or 40 per cent. Of the $46 billion savings bonds outstanding, only $2 billion matures within five years, but all are redeemable upon demand and thus constitute a potential short-term liability.



Maturity Distribution of U. S. Government Publicly-Held Debt as of July 31, 1945

This building up of short-term debt during the course of the war financing was the result of deliberate policy, as indicated by former Secretary Morgenthau in his summary report for the fiscal year 1945 when he stated:

> The policy of fitting the security to the needs of the investor makes it inevitable that a large portion of the public debt should consist of short-term securities. This is a good thing for the investor, a good thing for the Government, and a good thing for the economy as a whole.
>
> It permits liquid funds to be shifted readily between currency and bank deposits; and permits bank deposits to be shifted readily from one bank to another, and from one section to another, without strain on the money market. It likewise permits corporations and other businesses to apply their tax reserves to the payment of taxes, and their reconversion reserves to the expenses of reconversion without money market strain.

Moreover, under the pattern of interest rates prevailing, short-term financing has been considerably more economical to the Treasury than a policy of funding.

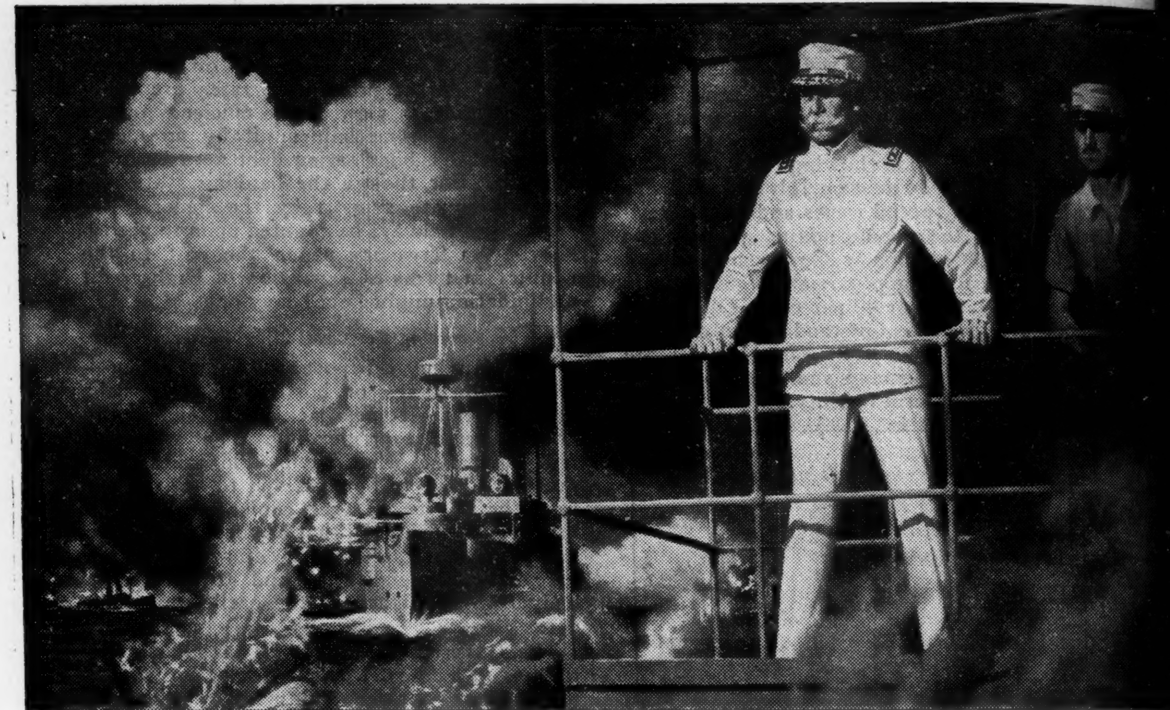
It may be granted that the arguments in support of a policy of short-term debt have force, but there is another side to the story. Advantages of a floating debt would be considerably diminished if short-term interest rates should rise, and the need for liquid means of investment in the market could be satisfied with a much smaller total. While fears of a crisis in which the Treasury would be unable to float new loans to pay off maturing issues except at prohibitive rates are probably extreme, in view of the efficiency of the money market mechanism, it by no means follows that a big floating debt need be of no concern. For though the banking system—given adequate support by the Federal Reserve — can always be counted upon to absorb short-term Treasury paper, the cost to the country in terms of expansion of bank credit and inflation might be a heavy one.

Spending the Controlling Factor

All planning on postwar fiscal policy—whether on taxes, on borrowing, or on debt management — comes back in the end to the policies pursued on spending. What we spend will determine what we pay in taxes, how much we have to borrow, and to a large extent the degree of free choice we have in handling the debt. All that has been said above has been predicated on a determined effort to control expenditures, and to bring the budget to a balance at the earliest possible date.

The Government cannot go on indefinitely running at a deficit without storing up trouble for itself and for the country. It may appear to be getting on all right, and people may be led to a false sense of security because nothing unpleasant seems to happen. The danger is that we are driving a lot these days without red lights. The usual warning signals have been taken down or — more misleading still — are often fixed on green. If we look at the bond market and note the prices at which government securities are selling, we seem to be getting the green light on government spending. Yet were it not for the machinery of money market control and for the billions of dollars of credit created by the banking system and used in the purchase of government securities, interest rates and bond quotations would present a different picture.

These conditions in the market have weakened the resistance to spending proposals and created an indifference to the growth of debt which, unless changed, will postpone indefinitely our reaching a balanced budget. It will mean more debt, more taxes, and more leaning upon government, when people ought instead to be working out their own problems individually in ways that have built up this country in the past. The bill now before the Congress proposing to establish the principle of government responsibility for spending and "investment" to promote "full employment" represents a natural and logical culmination of more than ten years of policies tending to foster the idea that finance is no problem at all, that the Government can get its money easily, and that there is an inexhaustible fund of resources available to the Treasury.



"You may fire when ready, Gridley." *As Commodore George Dewey in 1898 gave this historic command at Manila Bay, Captain C. V. Gridley of the Olympia was ready, and the flagship opened fire. The U. S. Asiatic Squadron was ready, and by winning the greatest naval triumph in American history at that time, opened the world drama in which the latest act was the triumphal fulfillment of General MacArthur's promise, "I will return."*

Ready at Manila

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